

**COMMENTS
of the
National Consumer Law Center
on behalf of its low-income clients**

and

**National Association of Consumer Advocates
Advocates for Basic Legal Equality, Inc. and
Virginia Poverty Law Center**

to

**Board of Governors of the Federal Reserve System
Regarding Regulation Z, 12 C.F.R. Part 226
Amended Interim Regulations under
the Mortgage Disclosure Improvement Act
[Docket No. R-1366, 75 Fed. Reg. 81836 (Dec. 29, 2010)]**

Submitted February 28, 2011

I. Introduction

The National Consumer Law Center¹ respectfully submits the following comments on behalf of its low income clients, with the National Association of Consumer Advocates,²

¹ The **National Consumer Law Center, Inc. (NCLC)** is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of eighteen practice treatises and annual supplements on consumer credit laws, including *Truth In Lending*, (7th ed. 2010), *Cost of Credit: Regulation, Preemption, and Industry Abuses* (4th ed. 2009 and Supp.), and *Foreclosures* (3rd ed. 2010), as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. NCLC attorneys have written and advocated extensively on all aspects of consumer law affecting low-income people, conducted training for thousands of legal services and private attorneys on the law and litigation strategies to address predatory lending and other consumer law problems, and provided extensive oral and written testimony to numerous Congressional committees on these topics. NCLC's attorneys have been closely involved with the enactment of the all federal laws affecting consumer credit since the 1970s, and regularly provide extensive comments to the federal agencies on the regulations under these laws. These comments were written by NCLC attorneys Andrew Pizor and Alys Cohen.

² The **National Association of Consumer Advocates (NACA)** is a non-profit corporation whose members are private and public sector attorneys, legal services attorneys, law professors, and law students, whose primary focus involves the protection and representation of consumers. NACA's mission is to promote justice for all consumers.

Advocates for Basic Legal Equality, Inc., and Virginia Poverty Law Center. We welcome the opportunity to comment on the Board of Governors' amendment of the interim rule that previously implemented provisions of the Mortgage Disclosure and Improvement Act of 2008 (MDIA). Specifically, these comments address the amended definition of "negative amortization loan" (Interim Reg. Z § 226.18(s)(7)(v)) and the associated commentary published by the Board in the December 29, 2010 Federal Register.³ The amended definition and the new commentary are detrimental to consumer protection and safety and soundness. The Board should repeal the recent amendment and ban negative amortization entirely.

While these comments specifically address a narrow portion of the December amendment, they are directly related to comments we previously submitted in response to the Board's September 2010 announcement of the interim MDIA regulations.⁴ We are disappointed and concerned that the Board failed to address our previous comments as they remain relevant. As we previously recommended, in order to promote consumer understanding, the Board should take the following actions:

- Restore the payment schedule disclosure.
- Remove the interest rate disclosure.
- Retain the statutory warning in MDIA for adjustable rate mortgages that payments may vary based on interest rate changes.
- Clarify the disclosure of mortgage insurance payments.
- Clarify the disclosure of credit insurance.
- Require disclosure of projected tax and insurance costs for every loan.
- Correct the disclosure of negative amortization so that it accurately discloses the maximum payment for negatively amortizing loans.
- Improve the adjustable rate disclosures by requiring disclosure of the date the interest rate is set, bringing the definition of amortizing loan into accord with business practices, and requiring a more prominent teaser rate warning.
- Require a minimum 12-point font size.

II. Restore previous definition of negative amortization loan and correct commentary

In addition to our previous recommendations, we now recommend that the Board correct the amended definition of negative amortization loan. Prior to the December amendment, negative amortization loan was defined as: "a loan that permits payments resulting in negative amortization, other than a reverse mortgage subject to § 226.33."⁵ This definition was appropriate because it ensured that consumers would receive disclosures and warnings for all loans in which negative amortization could occur.

³ 75 Fed. Reg. 81836 (Dec. 29, 2010). Subsection 226.18(s) was added to Regulation Z by the interim rule announced on September 24, 2010. 75 Fed. Reg. 58469, 58482 (Sept. 24, 2010). There was no commentary on the definitions in clause (v) until the December 29, 2010 amendments.

⁴ Attached as Appendix A.

⁵ 12 C.F.R. § 226.18(s)(7)(v) as published in 75 Fed. Reg. 58469 (Sept. 24, 2010).

The revised definition and the new commentary pose a major problem because they limit the disclosures to a single loan product—payment-option adjustable-rate mortgages (POARMs). As a result, they create a grave risk to consumers and to safety and soundness by concealing negative amortization and the attendant risk of default. The last sentence of the new commentary crystallizes the problem: “Loans that do not meet the [revised] definition of negative amortization loan, **even if they may have negative amortization**, are amortizing loans and are disclosed under §§ 226.18(s)(2)(i) and 226.18(s)(3).” (Emph. added). This Orwellian redefinition of terminology is inherently deceptive and will hinder compliance. The Board must correct this problem by restoring the original definition of negative amortization loan and writing new commentary that ensures proper disclosure for all loans that permit negative amortization (whether certain or merely possible), other than reverse mortgages. In addition we renew our previous recommendation to ban negative amortization in consumer credit rather than rely on disclosure.

III. The revised definition promotes deception

Pursuant to the new definition, creditors will only include negative amortization disclosures in the payment and interest summary for POARMs.⁶ Other loans that will negatively amortize, or that are highly likely to do so, will be falsely described as “amortizing loans.”⁷ Such loans include the seasonal-income loans described in the commentary, loans in which the rate and payment adjust on different schedules, and ARMs with fixed payments. As a result, lenders will be able to legally conceal the risk of negative amortization from all but the most sophisticated borrowers. Limiting the negative amortization disclosure requirement to POARMs is utterly unfathomable and irrational.

As we have previously explained,⁸ and the Board’s own consumer testing demonstrates,⁹ negative amortization is too complex for most consumers to understand regardless of how it is disclosed. It is also dangerous because loans permitting negative amortization behave in a manner that is contrary to what most consumers expect. Nevertheless, if the Board will not ban negative amortization in consumer credit, the Board must at least mandate clear disclosure for all loans where negative amortization is possible.

⁶ The Federal Register notice and the new commentary leave some ambiguity regarding when loans would fit the definition of “negative amortization loan.” The Federal Register notice says the Board did not intend to include “transactions that do not provide for multiple payment options” in the definition of negative amortization loan. 75 Fed. Reg. at 81840. That would mean no loan with the possibility or certainty of negative amortization would be disclosed as a negative amortization loan, except POARMs. The new commentary, however, says of an example “[t]he possibility (but not certainty) of negative amortization occurring after consummation does not make [the example] a negative amortization loan” Does this mean the deciding factor in choosing disclosure regimes is whether the borrower is given multiple payment options or the likelihood of negative amortization?

⁷ OSC § 226.18(s)(7)-1.

⁸ See Appendix A at 15-18.

⁹ See 75 Fed. Reg. 58489, 58474 (Sept. 24, 2010) (describing results of consumer testing).

It is easy to envision a loan that would use the revised definition to conceal negative amortization. A fixed-payment ARM could have an initial rate at which the payment is fully amortizing until the first change date, but a margin that is sufficiently high to guarantee negative amortization based on the history of the index. The Board uses the following example in the new commentary:

Assume the initial rate is 4%, for which the fully amortizing payment is \$1500. Under the terms of the legal obligation, the consumer will make \$1500 monthly payments even if the interest rate increases, and the additional interest is capitalized.

Of this loan, the commentary says “[t]he possibility (but not certainty) of negative amortization occurring after consummation does not make this transaction a negative amortization loan for purposes of § 226.18(s).” Therefore this loan would be disclosed as an “amortizing loan.” The Board’s example, however, ignores what is *likely* to occur.

Let’s add some additional facts to this example. Assume future interest rate changes are calculated by adding a 3.9% margin to an index. The current index rate is 1% and the index rate has never been lower than .2%. Under the Board’s revised interim rule, this loan will still be disclosed as an “amortizing loan” even though negative amortization is all but certain after the first change date.¹⁰ The payment and interest summary disclosure will be highly deceptive.

Because most consumers focus on the monthly payment,¹¹ the use of a fixed payment without adequate warnings would also be likely to mislead the typical consumer into believing the loan had a fixed rate. The Board provides no explanation of why it believes this is acceptable nor does the Board acknowledge that borrowers obtaining such loans are as likely—if not more likely—to face the same risks as POARM borrowers.¹²

The Board appears to incorrectly assume negative amortization is more likely, or a greater risk, in POARMs than anywhere else. While POARMs have wreaked havoc on homeowners and the economy and are correctly included in the definition of negative amortization loan, they are only the latest fashion in negative amortization. The definition must be more comprehensive to protect and inform consumers. With POARMs, the borrower is at least presented each month with the option of making a fully-amortizing payment (affordability aside). In contrast, if a different type of loan only gives the borrower one payment option—a fixed payment that is too low or too infrequent to cover the accruing interest—the borrower is much more likely to pay the non-amortizing payment amount. This is true for two reasons: the typical borrower will not take the extra effort needed to make an additional payment toward

¹⁰ Negative amortization is all but certain after the initial rate expires because future rates will almost certainly be at least 4.1%, assuming the index remains within its historical range.

¹¹ See 75 Fed. Reg. 58489, 58474 (Sept. 24, 2010) (describing results of consumer testing).

¹² This type of loan would also include the potential for an unexpected balloon payment at maturity, in order to payoff any accumulated negative amortization. This could vastly exceed the potential for “payment shock” present in typical POARMs.

principal; and the non-amortizing payment will be the only payment amount appearing on the bill or automatically deducted from the borrower's bank account.

IV. Conclusion

The easiest way to resolve the problems with the revised definition of negative amortization loan is to undo the revision—by reinstating the original definition and deleting the new commentary so the potential for negative amortization is disclosed in all circumstances. Relying on gimmicks, such as tying the disclosure requirement to the use of multiple payment options or the likelihood of negative amortization, will only allow disreputable creditors to evade the rules.

Appendix A

COMMENTS
of the
National Consumer Law Center,¹ the Center for Responsible Lending,² and the National
Association of Consumer Advocates³
to the Board of Governors of the Federal Reserve System
[Docket No. R-1366]
Regarding Interim Regulations under
the Mortgage Disclosure Improvement Act
November 23, 2010

I. Introduction

We welcome the opportunity to comment on the Board of Governors' interim rule that implements certain provisions of the Mortgage Disclosure and Improvement Act of 2008 (MDIA). Specifically, these comments address the Interim Reg. Z § 226.18(s) related to the interest rate and payment summaries. As the Board has previously recognized, ensuring accurate and timely disclosures in the mortgage market is imperative.⁴ We continue to find much to praise in the Board's approach to interest rate adjustments and payment changes.⁵ However, we are disappointed in the Board's failure to correct significant flaws in the proposed rule and troubled by the Board's disregard of statutory mandates.

In order to promote consumer understanding, the Board should take the following actions:

- Restore the payment schedule disclosure.

¹ **The National Consumer Law Center, Inc.** (NCLC) is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of eighteen practice treatises and annual supplements on consumer credit laws, including *Truth In Lending* (6th ed. 2007), *Cost of Credit: Regulation, Preemption, and Industry Abuses* (4th ed. 2009), and *Foreclosures* (3d ed. 2010), as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. NCLC attorneys have written and advocated extensively on all aspects of consumer law affecting low-income people, conducted training for thousands of legal services and private attorneys on the law and litigation strategies to deal predatory lending and other consumer law problems and provided extensive oral and written testimony to numerous Congressional committees on these topics. NCLC's attorneys have been closely involved with the enactment of the all federal laws affecting consumer credit since the 1970s and regularly provide extensive comments to the federal agencies on the regulations under these laws. These comments are filed on behalf of NCLC's low-income clients and were written by Alys Cohen, Diane E. Thompson, and Tara Twomey.

² **The Center for Responsible Lending** is dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. A non-profit, non-partisan research and policy organization, CRL promotes responsible lending practices and access to fair terms of credit for low-wealth families. CRL is affiliated with the Center for Community Self-Help, one of the nation's largest non-profit community development financial institutions.

³ The **National Association of Consumer Advocates** (NACA) is a non-profit corporation whose members are private and public sector attorneys, legal services attorneys, law professors, and law students, whose primary focus involves the protection and representation of consumers. NACA's mission is to promote justice for all consumers.

⁴ 73 Fed. Reg. 1672, 1715-1716 (Jan. 9, 2008).

⁵ See generally Comments of National Consumer Law Ctr., et al., to the Fed. Res. Board 110-142 (Dec. 24, 2009), http://www.nclc.org/images/pdf/foreclosure_mortgage/predatory_mortgage_lending/r-1366-with-app-dec09.pdf.

- Remove the interest rate disclosure.
- Retain the statutory warning in MDIA for adjustable rate mortgages that payments may vary based on interest rate changes.
- Clarify the disclosure of mortgage insurance payments.
- Clarify the disclosure of credit insurance.
- Require disclosure of projected tax and insurance costs for every loan.
- Correct the disclosure of negative amortization so that it accurately discloses the maximum payment for negatively amortizing loans.
- Improve the adjustable rate disclosures by requiring disclosure of the date the interest rate is set, bringing the definition of amortizing loan into accord with business practices, and requiring a more prominent teaser rate warning.
- Require a minimum 12-point font size.

II. The Board should not abandon the payment schedule.

The Board summarily proposes to abandon the disclosure of the payment schedule and the disclosure of the total of payments.⁶ Both the payment schedule and the disclosure of the total of payments are required by the statute.⁷

MDIA specifically contemplates the retention of the existing payment schedule. It does not authorize the removal of the payment schedule even for adjustable rate mortgages, let alone fixed rate mortgages. The MDIA disclosures are mandated “in addition to the other disclosures required by subsection (a).”⁸

The Board indicates that the current payment schedule was ineffective in communicating to consumers what could happen to their loan payments over time, particularly with respect to adjustable rate loans. We agree. However, it is equally clear that borrowers like the payment schedule because it provides specific and detailed information about their future payments.⁹ While consumers have difficulty understanding the impact of rates on a loan, consumers intuitively understand monthly payments.¹⁰ Monthly payments are stated in dollar amounts. Those dollar amounts mean something to consumers in their budgets. Moreover, the scale of the monthly payment is within the daily experiences of most borrowers.

⁶ 75 Fed. Reg. 58,470 (Sept. 24, 2010).

⁷ 15 U.S.C. § 1638(a)(5), (6).

⁸ 15 U.S.C. § 1638(b)(C).

⁹ Macro International, Inc., Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages 12 (July 16, 2009).

¹⁰ See Lauren E. Willis, Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price, 65 Md. L. Rev. 707, 781-782 (2006). Consumers often have trouble intuitively understanding large numbers, particularly when those large numbers do not need to be paid until well into the future. Rates, while extremely important for comparative purposes, are less helpful when borrowers want to manipulate the numbers and determine their actual payment amounts. Most consumers have trouble performing even simple mathematical operations using percentages. Leda Cosmides & John Tooby, Are Humans Good Intuitive Statisticians After All? Rethinking Some Conclusions from the Literature on Judgment Under Uncertainty, 58 Cognition 1, 18 (1996); Justin Kruger & Patrick Vargas, Consumer Confusion of Percent Differences, 18 J. Consumer Psychol. 1 (2008) (also available at <http://ssrn.com/abstract=946238>).

The Interest Rate and Payment Summary section described in Interim Reg. Z § 226.18(s) replaces the former payment schedule with a new table format, adds new interest rate and escrow disclosures, and imposes a new requirement “to disclosure the maximum possible interest rate and payments” for adjustable rate mortgages (ARMs) and step-up mortgages. These changes should counteract borrowers’ natural tendency to underestimate the effect that rate increases could have on their payments.¹¹ However, the new format of the payment disclosures falls short of its goal to provide meaningful disclosure of credit terms and to enable consumers to compare credit terms available in the marketplace. While we strongly support the prominence accorded the maximum payment disclosures, we encourage the Board to consider testing alternative disclosure formats that will incorporate the disclosure of the number, amount, due dates or period of payments necessary to repay the loan. The maximum payment disclosures should supplement the payment schedule, not replace it.

The specific payment summaries the Board proposes are important for mortgage credit, but they do not afford consumers a sense of how and when the payments may change. Some consumers currently use the existing disclosures as a guide to when their payments will increase and by how much. While the new disclosure warns of the maximum payment, and thus permits risk assessment, it requires homeowners to read the fine print of their notes to have any notion of how often payments will change. By removing the payment schedule, the Board hides key information.

The omission of the payment schedule and the total of payments undercuts a core purpose of TILA: the comparability of credit. Consumers will lose information with which to choose between mortgage products; the ability of consumers to comparison shop across types of credit is even further diminished by this proposal. This information is essential when comparison shopping under the new early disclosure regime under TILA.

The Board apparently relies on its authority under 15 U.S.C. § 1604(a) to make classifications and exceptions as “are necessary or proper to effectuate the purposes of this subchapter, to prevent circumvention or evasion thereof, or to facilitate compliance therewith.” Removal of key statutorily-mandated language does not enhance consumer protection nor ease compliance with the statute. Since the Board does not explain why, in its judgment, removal of two statutorily mandated disclosures is necessary to effectuate the purposes of TILA, the Board’s action appears arbitrary and capricious and beyond its authority.

III. The interest rate disclosure should be removed.

The dual disclosure of the interest rate and the APR on the same form may make the disclosure of the APR not clear and conspicuous. Creditors have often put the interest rate on the TIL disclosure in order to undermine the prominence of the APR.¹² Particularly since the interest rate is lower than the APR—and the interest rate at subsequent adjustments may also be

¹¹ Elizabeth Renuart and Diane E. Thompson, *The Truth, the Whole Truth, and Nothing but the Truth: Fulfilling the Promise of Truth in Lending*, 25 *Yale J. on Reg.* 181, 211-13 (2008).

¹² *See, e.g., Andrews v. Chevy Chase, F.S.B.*, 240 F.R.D. 612 (E.D. Wis. 2007), *rev’d on other grounds*, 545 F.3d 570 (7th Cir. 2008).

lower than the APR—disclosing the interest rate with the APR allows creditors to downplay the actual cost of credit.

The key point for consumers is not that their interest rates will change, but that their payments will change. Understanding of interest rate fluctuations is irrelevant for the crude risk assessment many families make when taking out a loan: can we make the monthly payment? The Board should focus on the key information for homeowners, the payments, and ignore the less relevant and potentially confusing information, the interest rate.

The Board notes that its consumer testing shows that consumers are interested in knowing the interest rate of the loan.¹³ The Board did not do any testing, however, as to whether the dual disclosure of the APR and the interest rate undermines the disclosure of the APR. Before adding extraneous information to the TIL disclosure, the Board should confirm that consumers are not confused or misled.

IV. The statutory warning in MDIA that payments may vary should be retained.

MDIA mandates that consumers be told that “Payments Will Vary Based on Interest Rate Changes.”¹⁴ The mandate exists to warn consumers that the payments reported on the TIL disclosure are not fixed and are subject to change.

Yet the Board is replacing this warning with the title “Interest Rate and Payment Summary.”¹⁵ The Board asserts that this is a “plain language” substitution. The title “Interest Rate and Payment Summary,” however, does not convey the same information as the MDIA warning: that payments will change and that the disclosure of payments is not a disclosure of actual payments. Giving prominence to an interest rate summary may also distract from the central role of the APR disclosure.

Again, the Board is choosing to exercise its exception authority under 15 U.S.C. § 1604(a) without justification, in an apparently arbitrary and capricious fashion.

V. Lack of a payment schedule makes disclosure of mortgage insurance premiums confusing.

The Homeowners Protection Act of 1998 limits the amount of private mortgage insurance (PMI) consumers can be required to purchase.¹⁶ Borrowers may request cancellation of PMI under some circumstances, and creditors must terminate PMI automatically when certain conditions are met.

In 1999, the Board amended the Commentary to provide that payment schedules reflect the consumer’s mortgage insurance payments until the date on which the creditor must

¹³ 75 Fed. Reg. 58,470, 58,474 (Sept. 24, 2009).

¹⁴ 15 U.S.C. § 1638(b)(2)(C).

¹⁵ 75 Fed. Reg. 58,470, 58,474 (Sept. 24, 2009).

¹⁶ 12 U.S.C. §§ 4901, et seq.

automatically terminate coverage. This date occurs when the principal balance owed is 78% of the sale price. Under the existing payment schedule disclosure, creditors are required to list a certain number of payments in a monthly amount that included the mortgage insurance premium followed by the remaining number of payments in an amount that did not reflect the premium.¹⁷ The payment schedule would reflect a drop-off when the mortgage premiums terminated. The previous staff commentary illustrated how mortgage premiums should be disclosed on the payment schedule when some premiums are collected and escrowed at the time the loan is closed.¹⁸

The Board has carried this example over to the payment amount disclosures under the Interim Regulation without clarifying how this works in the absence of a payment schedule. It is uncertain what it means to include mortgage insurance premiums in the payment amounts “until the date on which the creditor must automatically terminate coverage,” when there are no dates disclosed on the payment summary and typically only one payment amount. For example, borrowers with fixed-rate loans will presumably receive no disclosure of the drop in payment as a result of the termination of their mortgage insurance premium because the interest rate and payment summary provide for the disclosure of only the fixed-rate and initial payment. As noted above, we urge the Board to consider further testing of formats that will demonstrate this anticipated payment reduction.

VI. The treatment of credit insurance must be clarified.

The Board provides that credit insurance should not be included in the payment disclosure.¹⁹ This is in distinction to the current rule, which requires such payments to be included in the payment schedule if they are finance charges and permits them to be included even if they are not financed.²⁰

Financed credit insurance will be a finance charge under most circumstances, in those limited circumstances where it is permitted. Presumably, homeowners should be informed of its presence in the payment disclosures they are provided, even if creditors are not permitted to include it in escrow disclosures. The Board should clarify where and how payments for credit insurance are disclosed.

VII. Require escrow disclosures for all loans.

In commenting on the proposed rule, consumer advocates and most creditors agreed that estimated taxes and insurance should be included in the payment summary tables. However, the Board elected to make no changes in this regard and only require disclosure where there is an escrow account associated with the loan. We believe that the disclosure of tax and insurance payments for all loans is critical to borrowers’ understanding of their loan costs, regardless of whether the creditor establishes an escrow account. The failure to require any escrow-related

¹⁷ Official Staff Commentary § 226.18(s)(3)(i)(C)-2; Old Official Staff Commentary § 226.18(g)-5.

¹⁸ Old Official Staff Commentary § 226.18(g)-5; 68 Fed. Reg. 16,185 (Apr. 3, 2003).

¹⁹ Official Staff Commentary § 226.18(s)(3)(i)(C).

²⁰ Official Staff Commentary § 226.18(g)-1.

information for loans without an escrow account is a critical omission in the interim rule.²¹ This omission actually rewards creditors who do not provide escrow accounts and allows them to present themselves as offering a cheaper product.

Consumers need two types of escrow disclosure: a statement of whether the loan will include an escrow account, and the disclosure of what the monthly escrow payments will be. Escrow disclosures are important—even where the creditor does not require an escrow account—because virtually all borrowers must pay property taxes and insurance (T&I) for their homes. When creditors do not collect the T&I payments through an escrow account, many consumers fail to budget for these payments when calculating loan affordability, or they mistakenly assume the lender has already included escrow payments in the disclosed periodic payment amount. The Board has repeatedly recognized the importance of escrow accounts.²²

Predatory lenders have taken advantage of borrowers' lack of understanding of escrows by refinancing loans that include escrow accounts with new—more expensive—loans that do not include escrow accounts. A consumer who sees a disclosure statement reflecting the principal and interest (P&I) payment for the new loan is often deceptively encouraged to compare it to the payment on the existing loan (the one being refinanced). If the payment on the old loan includes principal, interest, taxes and insurance (PITI), the new P&I payment will appear more affordable than the PITI payment on a strictly numerical basis unless the disclosure statement clearly warns the borrower that the new P&I payment does not include escrow. This “escrow not included” warning should be in close proximity to the payment amount and should include the estimated cost of T&I.

Because the Board does not currently require this disclosure, consumers often fail to realize that the new loan is more expensive until they receive a notice that tax payments are delinquent or that their insurance is being canceled for non-payment. This has a domino effect that often leads to the servicer establishing an escrow account with expensive force-placed insurance, thereby causing the borrower's monthly payments to increase, which then pushes the borrower into default and foreclosure.

As proposed, creditors must disclose: “That an escrow account is required, if applicable, and an estimate of the amount of taxes and insurance, including any mortgage insurance[.]” Interim Reg. Z § 226.18(s)(3)(i)(C). In addition, the proposed commentary says that a creditor need only make the escrow disclosures if the creditor plans to open an escrow account. Interim Official Staff Commentary § 266.18(s)(3)(i)(C)-1. To consumers' detriment, nothing requires disclosure of escrow-related information for loans without an escrow account. To help consumers protect themselves from scams, the Board must require: a) disclosure of the same escrow payment information as required for loans with escrow accounts; and b) a clear, prominent warning that the loan does not include an escrow account and that the borrower must make the T&I payments on their own. The new Dodd-Frank provisions make clear that loan affordability includes an analysis of taxes and insurance.²³ Lenders should provide homeowners that same ability to review the whole of their loan payment.

²¹ Interim Reg. Z § 226.18(s)(3)(i)(C).

²² See, e.g., 73 Fed. Reg. 44,522, 44,613 (July 30, 2008) (requiring escrow accounts for higher-priced loans).

²³ Pub. L. No. 111-203, 124 Stat. 1376, §§ 1422, 1461, 1462 (July 21, 2010).

VIII. Negative amortization and payment option disclosures are deeply flawed.

As noted in our comments on the proposed rule, negative amortization and payment option ARMs are so complex that truly effective disclosure is impossible. If the Board continues to allow negative amortization loans, however, the interest and payment disclosures should be re-evaluated and subjected to additional consumer testing.

a. Interest and payment disclosures are confusing, incompatible with amortizing ARM disclosures, and incomplete.

The interim disclosures for amortizing, adjustable-rate mortgages will show the interest rate and periodic payment amount for the introductory rate; the maximum rate and payment at the first adjustment; and the maximum rate and payment that may ever come into existence at any time until the loan matures. While those disclosures appropriately educate the consumer on the potential cost of an ARM, interim § 226.18(s) does not meet TILA's mandate to facilitate comparison between different loans because it will be hard for consumers to compare the ARM disclosures to the negative amortization disclosures. The negative amortization disclosures will use different labels and different columns, and will not clearly identify the maximum payment. Additionally, the phrase “minimum payment” on the payment option disclosures could be confusing to consumers familiar with how the same phrase is used on credit card statements. On a credit card, the “minimum payment” will eventually pay off the total balance (assuming no new purchases or fees). On a POARM, however, the “minimum payment” does not pay off the balance—instead it makes the balance grow larger.

The way a negative amortization loan reaches the maximum possible payment is also more complex and difficult to explain to consumers than the maximum payment on fully-amortizing ARMs. If a borrower does not understand the circumstances under which a loan could reach the maximum possible payment, the borrower will not be able to evaluate the risk posed by the loan terms. The model form sample for a POARM (H-4(G)) appears to disclose the maximum payment by assuming the interest rate reaches the maximum possible interest rate as early as possible. However, that would not produce the maximum possible payment for a typical POARM.

For most ARMs, the maximum payment should be calculated by applying the maximum interest rate permitted by the note to the remaining principal balance, assuming payments will be made as agreed under the note on the earliest date that the maximum interest rate could apply. In contrast, for payment option ARMs, the maximum payment depends on the interplay between the permissible amount of negative amortization, the highest interest rate, and the latest date at which the payments become fully amortizing. The maximum payment for payment option ARMs is triggered when the maximum interest rate is applied to the maximum loan balance for the shortest amortization period. This will happen when the onset of fully amortizing payments is delayed as long as possible, and often results when the interest rate does not immediately go to the maximum amount possible. Indeed, for POARMs, borrowers will ultimately pay lower

monthly payments if the interest rate goes quickly to the maximum possible—because of the impact of an extended amortization period.²⁴

For most payment option ARMs, the maximum payment should be calculated applying the maximum interest rate to the maximum negative amortization after the longest permissible period of time for non-fully amortizing payments, typically five years. For example, if the original loan amount was \$200,000 and the minimum monthly payment was \$690.24 with an initial rate of 1.5% interest for the first payment, this loan would reach the maximum possible payment under the terms of the note on the 61st payment if the interest rate rose to about 6.77% on the first adjustment and remained the same until the 61st month when it rose again to 10.5%. This maximum possible payment on this loan would be \$2,171.19 and the maximum principal balance would be \$229,795.10. In the absence of a clear explanation of these details, a borrower comparing a fully-amortizing ARM and a POARM would not be able to accurately evaluate the risk posed by the differing loan terms and payment options.

In failing to address these details, the Board does not serve homeowners well. As the Board acknowledges, homeowners are driven by the size of their monthly payment and do not understand the relationship between the interest rate and monthly payment. The Board's payment disclosure for negatively amortizing loans understates the potential risk for homeowners and simplifies to the point of irrelevance the relationship between the interest rate, other loan terms, and the monthly payment.

Negative amortization disclosures are further complicated by the differences between the various payment options. While the Board's proposal to disclose only the full and minimum payment options is logical, the proposed disclosures fail to explain that the disclosed full payment amount will increase if the borrower makes less than the full payment at any time during the option period. If the borrower elects to make the minimum payment (or any amount less than the full payment) just once, negative amortization will increase the loan balance and the full payment will increase in order to remain a fully amortizing payment. As a result, the Board's attempt to simplify the disclosures by omitting lengthy explanations results in a potentially misleading disclosure.

b. Improve disclosure of amount by which principal balance will increase

The proposed statement accompanying the maximum principal balance must be changed. The proposed model form warns consumers they "will borrow" additional money by a certain date if the borrower only makes the minimum payments. This statement should be redesigned to avoid potential misinterpretation, and so it has a more powerful impact on readers. The phrase "will borrow" could be misinterpreted by unsophisticated borrowers as an inducement to make the minimum payments—a consumer could read the statement as meaning the lender will give them more cash (as with a HELOC) by the listed date only if they make the minimum payments. Although this disclosure may be technically correct in the sense that negative amortization can be considered a further extension of credit, using the word "borrow" in this way is vastly different from the common understanding of the word. As a result, we encourage the Board to use consumer testing to further refine these disclosures.

²⁴ HAMP, for example, uses an extended amortization period in an attempt to make monthly payments affordable.

IX. Improve the adjustable rate disclosures

a. Disclose the date the interest rate is set.

The interest rate on an adjustable rate loan is determined by adding the index value to the margin specified in the note. Index values typically move up or down each day. The “interest rate” for purposes of an adjustable rate loan is not defined in the interim regulation. However, the term “fully-indexed rate” is defined in the interim regulation as “the interest rate calculated using the index value and margin at the time of consummation.” Interim Reg. Z § 226.18(s)(7)(vi). The Official Staff Commentary notes that the “index in effect at consummation (or at the time of early disclosures) need not be used if a contract provides for a delay in the implementation of changes in an index value. For example, if the contract specifies that rate changes are based on the index value in effect the 45 days before the change date, creditors may use any index value in effect during the 45 days before consummation (or any earlier date of disclosure) in calculating the fully-indexed rate to be disclosed. Interim Official Staff Commentary § 266.18(s)(3)(i)(C)-1. Where, as here, the Board allows the creditor to use an index value within a range of days, the Board must require the creditor to disclose the date for the selected index value. If the date is not disclosed, anyone reviewing the disclosure for Regulation Z compliance will either need to guess at the date or obtain the creditor’s records—something that may require a subpoena or that may be impossible if the creditor is no longer in business.

The date could be disclosed in a sentence saying, “the interest rate for the loan described in this disclosure statement was set on *(date)*” and printed outside the grouped and segregated disclosures.

b. Clarify definition of “amortizing loan.”

In the interim regulation, the Board, without explanation, has used the same inaccurate definition of “amortizing loan” as in the proposed rule.²⁵ For purposes of the new interest rate and payment summaries in Interim Reg. Z § 226.18(s)(7)(ii), the interim rule defines an “amortizing loan” as a loan in which the regular payments cannot cause negative amortization. This means that loans traditionally not considered amortizing (such as interest-only notes) are “amortizing loans” for purposes of the interest rate and payment summaries.²⁶

This definition of “amortizing loan” is contrary to industry custom and the normal understanding of the term. It should be changed to avoid confusion. An amortizing loan is generally considered one in which regular monthly payments of principal and interest will pay off the loan by its maturity date. Often the term is used to describe a loan in which payments are credited to both principal and interest. The interim definition is not necessary and opens the door to confusion. Paragraph (s) would be easier to understand if the Board used more commonly recognized terminology, such as “loans that permit negative amortization,” “amortizing loans,” and “interest-only loans.”

²⁵ Compare Proposed Regulation Z § 226.18(c)(7)(ii) with Interim Rule Z § 226.18(s)(7)(ii).

²⁶ Interim Reg. Z § 226.18(s)(c)(7)(ii); Interim Official Staff Commentary Z § 226.18(s)-2.

c. Require a more prominent teaser rate warning.

The disclosure for discounted introductory rates (more commonly known as teaser rates) remains inadequate. MDIA specifically mandated that the TIL disclosure reveal “the fact that the initial regular payments are for a specific time period that will end on a certain date.”²⁷ The Board’s disclosure does not do this. The Model Clause (H-4(I)) does not even provide the date that the initial period expired on. Nor was the Board’s testing adequate to determine the “appropriate format” for warning consumers of this risk, as required by the statute.²⁸

The Board must make the teaser rate notice stronger and more prominent. Interim Reg. Z § 226.18(s)(2)(iii) requires only “[a] statement that, even if market rates do not change, the interest rate will increase at the first adjustment and the date of such rate adjustment; and [t]he fully-indexed rate.” The model form clause shows the fully-indexed rate; it does not show the resulting payment, which could be different from the maximum payment possible at the first adjustment; and it does not clearly convey that some loans have a guaranteed rate increase at the first adjustment. The use of the interest rate disclosure instead of disclosing the likely payment guarantees that consumers will underestimate the impact of the teaser rate.²⁹

We recognize that the Board tested alternative payment disclosures in Round 8 of the consumer testing, but we are concerned that the Board abandoned the tests too soon—after only one round. ICF Macro's report says "almost all participants understood from both the [tested] table and graph that even if market rates stayed the same, their payment would increase Several [participants] indicated that this surprised them, because this was not apparent from the first page of the TILA."³⁰ These observations are important for a number of reasons. The "first page of the TILA" used a payment and interest table very similar to the one adopted by the Board for the proposed regulations. The participants' observations indicate that the tested graph and table educated consumers on an important detail that the proposed disclosure table does not explain.

²⁷ 15 U.S.C. § 1638(b)(2)(C)(ii).

²⁸ 15 U.S.C. § 1638(b)(2)(C)(ii).

²⁹ See, e.g., U.S. Dep’t of Educ., National Center for Educ. Statistics, *Adult Literacy in America* 100 (Sept. 1993) (only 4% of US adults can calculate interest); Macro Int’l, Inc., *Design and Testing of Effective Truth in Lending Disclosures* 52 (2007), <http://www.federalreserve.gov/dcca/regulationz/20070523/Execsummary.pdf> 52 (“[V]ery few participants could accurately describe how interest charges were accurately calculated”); Annamaria Lusardi & Olivia S. Mitchell, *Baby Boomer Retirement Security: The Roles of Planning, Financial Literacy, and Housing Wealth*, 54 J. Monetary Econ. 205, 207, 216 (2007) (finding that less than 18% of surveyed adults between the ages of 51 and 56 could calculate compound interest at 10% on \$200 over 2 years); Danna Moore, Wash. St. U., Soc. & Econ. Sci. Research Ctr., *Survey Of Financial Literacy In Washington State: Knowledge, Behavior, Attitudes, and Experiences* (Tech. Rep. 03-39, 2003), available at <http://www.dfi.wa.gov/news/finlitsurvey.pdf> (finding approximately 30% of respondents do not understand that if interest compounds, it builds on itself); Annamaria Lusardi & Olivia S. Mitchell, *Financial Literacy and Planning: Implications for Retirement Wellbeing* 4, 7, Pension Research Council, Working Paper no. 1, 2006), available at <http://www.dartmouth.edu/~alusardi/Papers/FinancialLiteracy.pdf> (noting that only 67% of surveyed adults, many over 50, could correctly determine whether, after 5 years of interest at 2% on \$100, they would have less than, more than, or exactly \$102); Victor Stango & Jonathan Zinman, *How a Cognitive Bias Shapes Competition: Evidence from Consumer Credit Markets* 3-4, Sept. 5, 2006, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=928956 (finding most consumers underestimate interest rate by as much as 25 basis points).

³⁰ Macro International, Inc., *Design and Testing of Truth in Lending Disclosures for Closed-End Mortgages* 31 (July 16, 2009).

Because ICF did not conduct further testing on the graph or table from Round 8, we cannot know whether those disclosures were better than the introductory rate notice ultimately adopted or whether any of the flaws identified could be remedied. There was also no testing on whether the introductory rate notice would be more effective if it included the resulting payment and was in larger, bold letters elsewhere on the form. Before adopting final regulations, the Board should further test these and other ways to disclose the effect of teaser rates including variations of the payment disclosure table with more detail regarding whether the rate stays the same or increases to the maximum, a disclosure that shows only the initial and maximum payment without any intermediate adjustments or payment schedule, and the previously described details regarding the maximum possible payment on POARMs.

X. Require a minimum 12-point font size

Currently Regulation Z does not impose any minimum font size for closed-end credit disclosures. The interim regulation adds a 10-point minimum for the interest rate and payment summary tables.³¹ This is a welcome start, but 10-point text is still too small. There is a reason that 12-point type is the default in professional communications. The cliché regarding important details being hidden "in the fine print" has a strong basis in reality. The Board should impose a 12-point minimum for all important disclosures, in addition to the proposed 16-point minimum for the APR.

The Board specifically rejected previous calls for adopting a 12-point minimum by noting that testing shows consumers can "read and notice information in a 10-point font."³² The appropriate question, however, is not merely whether consumers can read and notice information. Many consumers can—if given sufficient time and light—probably read and notice information in even much smaller fonts—for example the 6-point font of this sentence. The question should be whether a 12-point font minimum would increase consumers' ability to read and identify important information. To the best of our knowledge, the Board has not conducted any consumer testing on this question.

Testing has already shown that font size has an impact on the effectiveness of disclosures.³³ Consumers will be more likely to read and identify information if disclosures are made in a larger font. Regulation Z should impose a 12-point minimum font for all of the mandatory mortgage disclosures. We have tested some of the proposed model forms using a 12-point font and found that the forms can still be used as designed, on a single page, with the larger font. The FRB itself notes that, "Consumer testing . . . showed that . . . the use of small print led many participants to miss or disregard key information about the loan transaction."³⁴

A 12-point minimum would also address an issue created by widespread use of the Adobe PDF format among computer users. Many creditors and settlement agents transfer disclosure statements by e-mail documents in Adobe PDF format.³⁵ Consumers receiving electronic disclosures are also likely to receive them in this format. The Adobe Reader software, a free, commonly used program for reading and printing PDF documents³⁶ has a printing feature called "Page Scaling" which allows the user to control the size of the electronic document as it appears on the printed page. The default Page Scaling setting is "Shrink to Printable Area," which reduces the size of the original document so it can be printed without risk of the edges being cut off by the printer (to 96% of the original size for one printer we tested, 94% for another). This means any disclosure statement written in a 10-point font may

³¹ Interim Reg. Z § 226.18(s)(1).

³² 74 Fed. Reg. 43,428, 43,441 (Aug. 26, 2009) (HELOC proposed rule).

³³ Macro International, Inc., Design and Testing of Effective Truth in Lending Disclosures iii, 7, 12, 15, 20 (May 16, 2007).

³⁴ 74 Fed. Reg. at 43,287.

³⁵ The FRB also uses PDF files on its own web site. See <http://www.federalreserve.gov/faqs.htm> (FAQ entitled "Why are some files in PDF format, and how can I read them?").

³⁶ The manufacturer of Adobe estimates "about half a billion people are running Adobe Reader." E-mail from Rick Borstein, Business Development Manager, Adobe Systems Inc. (Nov. 23, 2009).

ultimately be printed in a manner that results in the consumer receiving a 9-point or smaller font. Imposing a 12-point minimum would mitigate this problem.

XI. CONCLUSION

We appreciate the opportunity to comment on the Board's proposal. We urge the Board to revise its core proposals on the payment schedule, the disclosure of the interest rate, the adjustable rate loan warning, the disclosure of negative amortization and other adjustable rate loans, as well as proposals related to tax and insurance disclosure, private mortgage insurance, credit insurance and font size.